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PP RUEHAG RUEHDF RUEHIK RUEHLZ RUEHROV RUEHSL RUEHSR  
DE RUEHLO #1606/01 1911333  
ZNR UUUUU ZZH  
P 101333Z JUL 09  
FM AMEMBASSY LONDON  
TO RUEHC/SECSTATE WASHDC PRIORITY 2855  
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE PRIORITY  
RUCPDOG/DEPT OF COMMERCE WASHDC PRIORITY  
RUEATRS/DEPT OF TREASURY WASHDC PRIORITY  
RUEHBL/AMCONSUL BELFAST PRIORITY 1370  
RUEHED/AMCONSUL EDINBURGH PRIORITY 1173

UNCLAS SECTION 01 OF 03 LONDON 001606

SENSITIVE  
SIPDIS

E.O. 12958: N/A

TAGS: [ECON](#) [EFIN](#) [ETRD](#) [EINV](#) [UK](#)

SUBJECT: HMT UNVEILS PROPOSALS TO REFORM FINANCIAL MARKETS - NO BIG  
SURPRISES BUT OPENS DIVIDE WITH CONSERVATIVES

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¶1. (SBU) Summary: HM Treasury (HMT) published its White Paper on reforming financial markets July 8. The much anticipated proposals contained no big surprises. HMT supported the proposals outlined in the Financial Services Authority's (FSA's) Turner review, including strengthening capital and liquidity requirements. HMT plans to extend the FSA's powers and give it a formal, statutory objective for financial stability. The shape of the UK's institutional regulatory framework will remain unchanged but HMT will legislate to create a Council for Financial Stability. Chaired by the Chancellor, it will assess systemic risk through regular meetings. The White Paper ruled out the introduction of Glass-Steagall-type legislation and instead proposed changes to the UK's resolution regime. Internationally, the UK will continue to push for strengthened international regulatory architecture and an international mechanism for resolving failed multinational banks. HMT's proposals attracted fierce political opposition. Shadow Chancellor George Osborne said a Conservative government would abolish the Tripartite arrangement and give more power to the BOE. Industry response was muted but the sector was left uncertain as to the future structure of financial regulation in the UK post the next general election. End summary.

#### Reform to Banking Regulation

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¶2. (U) HMT's White Paper was written in response to its assessment of the origins of the financial crisis, namely that global standards of regulation failed to keep up with financial globalization and innovation. As such, regulatory reform forms a major component of HMT's proposals. Many of these proposals were outlined in regulatory chief Lord Turner's March report. The White Paper commits the Treasury to continued support of the Financial Services Authority (FSA) in its reform of banking regulation. Turner's key recommendations, which are supported in the White Paper, include increasing the quality and quantity of capital held by banks, increasing capital requirements for riskier trading activities, introducing a backstop "leverage ratio" that ensures minimum capital levels are maintained, and increasing liquidity regulation. The FSA will increase the intensity of its supervision of banks through its Supervisory Enhancement Program (SEP), including increased regulatory resources and greater focus on high impact firms. HMT supported the FSA's work on reducing the incentives created for excessive risk-taking by bank compensation structures. It said pay and bonuses should reward long-term sustainable growth, not short-term profits.

¶3. (U) In addition to supporting Turner's recommendations, the White Paper outlined a number of other regulatory reforms. HMT will extend the powers of the FSA by providing it with a formal, statutory objective for financial stability and giving it legal authority to set rules to protect wider financial stability. The FSA will be given extended powers to deal with individual

institutions through firm-specific interventions and will receive enhanced enforcement powers to deal with market misconduct. HMT will give the regulator power to keep the scope of regulation under constant review to determine what constitutes a systemically important institution and the ability to change regulation to cover these institutions as necessary.

#### Strengthening the Financial Stability Framework

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¶4. (U) The UK's institutional framework will remain unchanged. The FSA will continue to be responsible for conduct of business and prudential regulation for financial services firms, while the Bank of England will be responsible for overall stability of the financial system. However, the White Paper determines to improve coordination between the Tripartite authorities and strengthen their governance and transparency. In the fall, HMG will legislate to create a Council for Financial Stability, replacing the Tripartite's Standing Committee. The Council will consist of members from HMT, the FSA and the BOE and will be chaired by the Chancellor. It will hold regular standing meetings to discuss the assessment of systemic risk and to consider needed actions. Further meetings will be held when particular risks to financial stability are identified. The Council will provide a means of coordinating the activities of the authorities whenever necessary - in direct response to recent criticism that it is unclear which of the three authorities is in charge.

#### Proposals for Dealing with Failed Banks

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¶5. (U) Chancellor Darling outlined proposals to deal with risks posed by high impact firms. All firms will create detailed, practical resolution plans for dealing with their own failure. These plans will ensure their legal structure facilitates resolution

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if necessary. Plans will be evaluated by the BOE. HMT also called for improved infrastructure in securitization and derivatives markets to mitigate the risk of large, complex firms failing. Derivative markets, according to the White Paper, should be standardized, liquid, have price transparency and should be cleared through central counterparties. HMT rejected calls for the re-introduction of Glass-Steagall-type legislation. It said the current crisis highlighted that banks can fail and pose a systemic threat whether they are big or small, simple or complex.

#### International Priorities

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¶6. (U) HMT's White Paper acknowledged that much work needs to be done internationally and domestic regulation alone is insufficient to prevent a further crisis. It called for an international mechanism for resolving large multinational banks that get into difficulty and said the Chancellor would push this with G20 finance ministers later this year. Under its Presidency of the G20, the UK will continue to press for strengthened international regulatory architecture. It restated the UK's commitment to the principles agreed at the London Summit, particularly the creation of a new Financial Stability Board with a strengthened mandate. At the European level, the UK will push for enhanced monitoring of system-wide risks. HMT welcomed the findings of the de Larosiere report, particularly the June agreement to establish a European System of Financial Supervisors and new European Systemic Risk Board. It also responded positively to EU proposals on securitization which would require issuers to retain 5 percent of the risk to be securitized. On offshore banking centers, HMT is undertaking an independent review of long-term challenges facing British Crown Dependencies and Overseas Territories and will publish a final report at the end of this year.

#### Other Proposals: Deposit and Consumer Protection

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¶7. (U) The White Paper introduced a variety of other proposals on deposit and consumer protection. HMT will:

-- Introduce a pre-funded element to the Financial Services Compensation Scheme (FSCS), subject to further consultation, after ¶2012. The recent downturn, according to the report, has shown that the FSCS cannot meet the full costs of substantial failure immediately by raising levies from the industry.

-- Introduce a national money guidance service to provide additional support and protection for consumers.

-- Improve access to simple, transparent products so there is always an easily understandable option for consumers not looking for complex or sophisticated products.

-- Strengthen competition through increased coordination between the FSA and Office of Fair Trading.

#### Initial Reactions

¶18. (U) Shadow Chancellor George Osborne welcomed HMG's proposals to improve consumer advice and to implement a stronger resolution regime. However, in other respects, he said the government's paper was a "totally inadequate" response given the scale of the current crisis. He called it a white flag, rather than a white paper, and said it ducked all the difficult questions. He said the Tripartite agreement is dysfunctional and leads to inaction. He suggested Chancellor Darling should have buried the Tripartite system instead of reinforcing it. A Conservative government, he said, would abolish the Tripartite arrangement and put the BOE in charge of macro-prudential supervision. Alongside the Bank would be a powerful regulator to protect consumers and stop unfair practices.

¶19. (SBU) Industry reaction was more muted. Paul Chisnall, executive director of financial policy at the British Bankers' Association (BBA), told us he wasn't surprised by the proposals. He said HMT carefully crafted a responsible White Paper that was calm, well-reasoned and avoided "bank bashing." He argued it would be wrong to regard the proposals as a soft touch. HMG, he reasoned, took a very strong stance on ensuring major deposit-takers will face intense supervision and strict capital requirements. He said the proposals strengthen the UK's commitment to international coordinated action by giving the FSA a statutory requirement to monitor the international agenda. The next steps, he said, will include the publication of the Walker review on corporate governance, provisionally scheduled for July 16, and a fuller statement from the opposition on July 23.

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¶10. (SBU) Comment: HMT's White Paper did not introduce any major, unexpected reforms. While some proposals were new, many were outlined in Lord Turner's March report or had been leaked to the media. As such, industry reaction about specific aspects of the proposals has been muted. However, the White Paper and the following debate established a clear divide between Labour and Conservative financial policy. While Labour supports the Tripartite arrangement and plans to beef up the FSA's regulatory powers, a Conservative government would abolish the arrangement and hand power back to the BOE (power it lost in 1997 following the creation of the FSA.) This divide could create considerable uncertainty for the financial services industry. The future of UK financial supervision could largely be determined by the outcome of next year's general election.

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